

**Clyde V. Prestowitz  
President, Economic Strategy Institute**

**Testimony before the U.S.-China Economic and Security Review Commission  
“China’s Industrial Policy and its Impact on U.S. Companies, Workers and  
the American Economy”**

**March 24, 2009**

I’d like to thank the Commission for the opportunity to speak today on the China’s industrial strategy and its effect on the United States.

I have been watching China since the early 1980s and understand the important impacts it has had on the U.S. economy. From 1981-86, I was Assistant Secretary of Commerce, responsible for the Department of Commerce’s East Asian and China trade offices and leader of the first U.S. trade mission to China. Under President Clinton, I was vice-chairman of the President’s commission on trade and investment in Asia and since then have been a frequent visitor and witness to China’s incredible growth.

Since the late 1970s, China has gradually opened the doors of its economy to the outside world. Since then China has experienced rapid and indeed extraordinary growth. This growth has been achieved in part through the Chinese government’s adherence to a “catch-up,” export-led growth strategy similar to that of Japan and the so-called Asian Tigers – Korea, Taiwan, and Singapore. Not only has the government turned country into an export giant, it has become an export leader in certain strategic industries. At the beginning of February 2009, the Chinese State Council unveiled plans to bolster ten pillar industries that have been most affected by the current economic crisis. So far, detailed rescue plans have been released for the

automobile, steel, shipbuilding, machinery-manufacturing, electronics, information, textile and petrochemical industries. The support policies include expanding available credit for businesses, export rebates and tax rebates on imported components, and assistance in updating production technology.

To one unacquainted with China's industrial policies, this list of industries may seem at odds with a country that, while growing rapidly, is still relatively poor and whose main comparative advantage is its abundant labor supply. Products like consumer electronics or semiconductors are typically associated with much higher wage countries. In fact, the basket of goods produced in China is analogous in its technological advancement to that produced in a country with three times the per capita income.<sup>i</sup> These industries were targeted and pursued not because they complement China's natural strengths, but because they can provide positive externalities in areas like education, science, technology or national security. The growth potential in each of these areas was obviously significant; consumer electronics is an industry that did not exist in China circa 1982 but within 20 years, consumer electronics has become the country's largest industry, representing over 3 percent of Chinese GDP and 15 percent of total world output in the industry.<sup>ii</sup>

A key component of this strategy is achieving technology transfers by attracting foreign companies in the high-technology field to set up production and assembly facilities in China. Access to the Chinese market in some sectors requires foreign companies to enter into joint ventures with domestic manufacturers. Approval to enter into a joint venture may rest solely on the ability of a company to provide technology, and future improvements to that

technology. Foreign companies do not always get the freedom to select their joint venture partner, and may wind up working with a competitor – a competitor who will potentially have access to patents, production methods, and other intellectual property. In the case of consumer electronics, companies like Lenovo became the production partner for IBM's ThinkPad computers and once technology is transferred, become global powerhouses in their own right.

Unlike Korea and Japan, China has explicitly made inducing technology transfer via foreign investment a building block of its economic development. Thus China offers large capital grants and substantial tax abatement to selected foreign companies if they invest in China. Not only does China provide state support for its domestic and international industries through tax rebates and other types of funding, it also acts as gatekeeper in selecting which industries it will champion, and whether or not foreign companies may be selected to enter the market through a joint venture. China also uses moral suasion as a means of inducing foreign companies to invest and to transfer technology. This gives the Chinese government tremendous control over its market, and immediate access to technology it otherwise would have to develop independently.

For domestic businesses, state-owned banks undoubtedly play a major role in development. Within China there is no formal bond market, and thus no way for businesses to raise funds except through bank lending. The Chinese state-owned banks are providing loans based on government policies, funneling funds into strategic industries. This phenomenon does not look to end any time soon, as the most recent stimulus announcement calls for dramatically increased levels of credit for pillar industries.

Chinese industrial policy inevitably provides special treatment for domestic industries. Chinese industrial policy goes beyond identifying strategic industries in its domestic economy; it sometimes artificially prevents competition among its domestic producers, restricts foreign producer participation in certain domestic markets, and provides Chinese producers special advantages as exporters on the international market. China currently limits market access for some foreign goods and services, such as iron ore and auto parts, restricts exports through the use of quotas, license fees and minimum export prices, and implements unique national standards in high technology areas. The result of these policies is that China shores up its less competitive businesses, protecting them from any domestic or international competition, and promotes select industries that it wishes to make a pillar of its economy.<sup>iii</sup> Foreign investment in these industries is also controlled, through vague and arbitrarily enforced business laws. As a result, manufacturers in the United States often cannot export their goods to China, and are effectively shut out of the world's largest market. U.S. producers that do export to China may be faced with local content requirements or taxes.

A good example of how global markets may be affected is in raw materials. China is a key producer of several raw materials, such as coke. Exports of coke, used for making steel, are limited to 12 million metric tons per year. There is also a 40% duty on all coke exports. China produced around 350 million metric tons in 2007, and all but 12 million were sold domestically. Not only does this limit the supply available to foreign downstream producers, but it also affects the world price. In 2008, the price per metric ton in China was \$350, whereas the world price was \$750. This \$400 difference gives Chinese steel producers a competitive advantage over international producers.<sup>iv</sup>

Applying this pattern across other industries, it is easy to see how China takes advantage of market forces for the benefit of its producers. The affect on global markets, particularly on U.S. and other producers, is detrimental at best and catastrophic at worst. These policies could easily put smaller producers out of business, pricing them out of the market. If this trend were to continue, over the next five years what we will see are smaller businesses in the United States, and eventually larger ones, pushed out of the market. Our consumers will be paying artificially high prices for goods. The breadth of American industries involved that use raw materials from China – including steel, semiconductors, ceramics, aircraft, and medical imagery – means that hardly any sector of our economy will remain unaffected.

China presents a great challenge to the United States in terms of remaining competitive. China has an almost inexhaustible supply of inexpensive labor, highly trained scientists and engineers, and a comprehensive competitiveness strategy. But actually, China's industrial policy is less significant than America's lack of a strategy and its inability to maintain a highly trained work force; to interest and educate our students in the sciences and engineering; and to increase R&D efforts. For years our strategy has been not to have a strategy on the false assumption that market forces would always work to our advantage.

The next five years will be a critical time for the United States with respect to addressing competitiveness not only vis-à-vis China, but in general. If the United States does not get serious about making things in America and encouraging productive investment in America, it will not matter what impact China's policies have on the world market. The most level playing

field will not make the United States more competitive if we cannot create or produce innovative goods.

We are certainly at a disadvantage when it comes to Chinese state-owned companies and their access to government resources. Looking at the steel industry again, domestic Chinese producers receive subsidies, tax rebates, and loans at low or zero interest. The “Steel and Iron Industry Development Policy” established by the National Development and Reform Commission provides for direct subsidization of the steel industry, in the form of tax refunds discounted interest rates, funding for research, restriction of foreign investment, and export credits. The steel industry as a whole receives a 50% income tax reduction. The government allocated \$6 billion in 2000 for upgrades within the industry, and to transform capacity.<sup>v</sup> When currency manipulation is thrown into the mix, China has devised a policy to make its domestic steel industry almost impervious to outside market forces. China is now the world’s largest stainless steel producer, and its capacity continues to grow.

These direct and indirect subsidies make it difficult for any foreign producers to compete with China. It is imperative America respond so as to ensure competitive industrial capability in the United States.

I have already addressed China’s policy of forced technology transfer. It is a critical element of China’s support for its strategic industries and has allowed the country to climb the value-added production ladder much more quickly than might otherwise be possible. China has stated that its new aim is to achieve independent innovation. By 2020, it wants to establish its own science and research teams, and perform innovative research in manufacturing,

information technologies, aerospace, and defense. It has also announced that it is going to double R&D expenditures as a percentage of GDP. Although this should reduce the reliance China places on technology transfers, it will not eliminate it. Nor will these changes occur quickly. U.S. companies are still at the mercy of these forced technology transfers. Furthermore, they are frequently victims of trademark infringement and other forms of intellectual property theft.

The United States needs to be vigilant in responding to various Chinese policies and practices. But even more importantly, the United States needs to make sure that it is doing all it can to remain competitive, whether we are competing on a level playing field or not. This requires that we invest in domestic infrastructure and in R&D, that we invest in the education of our students, that we train a skilled workforce, and that we encourage investment in America by offering the same incentives as China and other countries. Although it is true that China stacks the deck in its favor, we cannot use Chinese industrial policy as a scapegoat for our own failings.

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<sup>i</sup> Rodrick, Dani. "What's So Special About China's Exports?" NBER Working Paper, January 2006. Pg 4

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<sup>ii</sup> Linden, Greg. "China Standard Time: A Study in Strategic Industrial Policy," *Business and Politics*, Vol 6, Issue 3, 2004. Pg 2

<sup>iii</sup> 2008 USTR Report to Congress on china's WTO Compliance, pg 6

<sup>iv</sup> 2008 USTR Report to Congress on china's WTO Compliance, pg 36

<sup>v</sup> "Specialty steel industry describes countless Chinese subsidies and their impact on capacity" *The Free Library* 16 April 2007. 20 March 2009 <[http://www.thefreelibrary.com/Specialty steel industry describes countless Chinese subsidies and...-a0181486550](http://www.thefreelibrary.com/Specialty+steel+industry+describes+countless+Chinese+subsidies+and...-a0181486550)>.

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